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STATE PASS FEDERAL RESERVE AND EXIMBANK
STATE PASS FEDERAL RESERVE SAN FRANCISCO TCURRAN
SINGAPORE PASS SBLEIWEIS
USDOC FOR 4430/MAC/EAP/MHOGGE
TREASURY FOR OASIA AND IRS
GENEVA FOR USTR

E.O. 12958: N/A
TAGS: ECON EFIN EINV PREL EXIM MY
SUBJECT: Malaysian Economy Improves - Growth May Resume by Year End

Ref A: Kuala Lumpur 2465, Ref B: 08 Kuala Lumpur 987

¶1. (SBU) SUMMARY and COMMENT: Bank Negara (BN) released second quarter 2009 (Q2) economic data August 26 showing a better than expected year-on-year quarterly GDP contraction of just 3.9 percent. GOM policy responses since November 2008 to the financial crisis including cutting reserve interest rates from 3.5 percent to 2.0 percent, reducing bank capital requirements, implementing two fiscal stimulus packages, liberalizing investment in some service sectors, and relaxing discriminatory Bumiputra investment laws have helped to stabilize the economy. Leading local economists project that the Malaysian economy is currently at the bottom and will return to growth before the end of the year. Those same economists, however, remain concerned with the potential future inflationary effects from growing GOM budget deficits, though inflation is low and there appears to be strong local demand at present for GOM securities. The GOM's real worry is the potential impact on GDP growth of dramatically reduced FDI flows and lower levels of domestic investment. We therefore anticipate more GOM reform initiatives targeted at stimulating FDI in the coming year, such as additional liberalization of the services sector. END SUMMARY and COMMENT.

Q2 GDP Results not as Weak as Expected

¶2. (SBU) Bank Negara released Q2 economic data August 26, announcing a Q2 GDP year-on-year contraction of 3.9 percent. This was far better than the 6.2 percent decline Q1 2009 GDP and led BN to project a cumulative 5 percent decrease in GDP for 2009. In meetings with Econoff, leading Malaysian economists and bankers have expressed a similar view that the worst of the economic crisis is behind Malaysia and that the economy is now at the bottom of the cycle. Rating Agency of Malaysia Chief Economist Dr. Yeah Kim Leng forecasts GDP growth to be zero or slightly negative in the third quarter 2009 and to increase to slight positive growth in the fourth quarter. Yeah predicted positive 2010 GDP growth of 2-3 percent but noted it would be well below pre-financial crisis levels. Malaysian Deposit Insurance Corp. (PIDM) Senior Economist Kevin Chew added that he expected GDP growth to begin to show improvement in Q3 and Q4, leaving Malaysia with a cumulative decline of 4.5 percent for the year. Chew also expects subpar growth in 2010. Malaysian Institute of Economic Research (MIER) Executive Director Dr. Mohamed Arif forecasts somewhat better cumulative results for 2009 at a 4.2 percent GDP decline, weak but steady growth for 2010 and 2011, with a return to pre-crisis growth levels in 2012.

Rising Unemployment Predictions Manageable

¶3. (SBU) Malaysia began the financial crisis one year ago at essentially full employment with a 3.3 percent unemployment rate. As of June 2009, official unemployment reached 4.0 percent but is not raising concerns for policymakers because consumption has remained strong. MIER's Arif projected official unemployment will peak in mid-2010 at 4.5 percent to 4.8 percent but he does not view this level as a major cause for concern. The 1.2 million legal foreign national guest workers in Malaysia, apparently took the brunt of lay-offs as export-driven manufacturers cut 7 percent of their pre-crisis workforces, according to Arif. Arif added that many of those job losses do not appear in official statistics, which only include Malaysian nationals.

Exports and Imports Rebounding

¶4. (SBU) Malaysian exports continued their poor performance in Q2 2009 declining nearly 30 percent from the previous year and 0.7 percent from the previous quarter. However, export performance in June was an improvement over April and May. Citibank Malaysia CEO Sanjeev Nanavati told us that Citi's exporter customers are seeing rapid improvements in orders and deliveries and he expects a much improved export performance in Q3. Because Malaysian imports have declined at the same pace as exports, there has been no pressure on the balance of payment accounts and GOM reserves improved to 91 billion dollars, a substantial 9 months of import coverage.

Inflation Plummets in Q2 Spiking Real Interest Rates

¶5. (SBU) Arif noted a steep drop in inflation in June caused a spike in real interest rates, removing the incentives to borrow and potentially derailing the stimulus effects of lower reference interest rates. The core CPI fell from 2.2 percent inflation in May to 1.8 percent year-on-year disinflation in June. As a result, real interest rates increased from slightly negative to nearly 4 percent, tightening monetary policy in real terms. BN reported disinflation also occurred in July and their Capital Markets Committee announced August 25 no change to the BN reference interest rate at 2.0 percent. BN cited substantial improvements in both Malaysian business confidence and consumer confidence indexes in support of its view that disinflation will not last long.

¶6. (SBU) Causes of the disinflation could include lag effects from the decrease in manufacturing activity and continuing reductions in Malaysia's money supply growth. M1, M2, and M3 money supply indicators are growing at significantly lower rates than prior to the crisis and BN announced that M3 grew during Q2 at a lower rate than during Q1. When asked about restricting monetary growth in the midst of a financial crisis, BN monetary policy officials responded that it is normal for BN to remove excess liquidity in the system during economic slowdowns.

Banks Stable and Well-Capitalized

¶7. (SBU) The Malaysian banking system appears solid and ready to lend, according to PIDM Senior Economist Chew. Banks have better capital adequacy and non-performing loan levels are down since the beginning of the crisis and were profitable in Q2. Credit approvals and loan disbursements started to grow again in Q2 and Chew anticipated single digit credit growth for all of 2009. Nanavati added that Citi's portfolio is strong and its commercial and consumer customers initially used cash balances to pay down debt but have recently started borrowing again as economic conditions have improved.

Fiscal Deficit Possible Looming Problem

¶8. (SBU) The MOF officially projects Malaysia's 2009 fiscal deficit

at 7.6 percent of GDP. Arif and Yeah project a higher 2009 deficit, in the 8 percent to 8.5 percent range, and a 2010 deficit in the 9 percent to 10 percent range or higher unless the GOM substantially reduces subsidies or increases taxes, both politically difficult options. The economists expressed concern that the high deficits will eventually be inflationary and weaken the Malaysian currency. Nanavati, however, asserted that there was great local demand for GOM debt and that the government will have no trouble funding its deficits. In support of his view, he cited a recent Citibank-led 4 billion dollar Petronas bond issue which was four times oversubscribed. Nanavati noted that Malaysia had plenty of investable capital with a 40 percent savings rate and Malaysians prefer investing in safe GOM securities.

Fall in Foreign and Domestic Investment Causing Real Concern

¶9. (SBU) While there are mixed views on the growing fiscal deficit, Malaysian policymakers are deeply concerned about the precipitous fall in both foreign and domestic investment in 2009. MIER statistics show FDI approvals are down 76 percent to 1.2 billion dollars for the first five months of 2009 compared to 5.1 billion dollars during the same period in 2008. Domestic investment declined 42.7 percent to 1.4 billion dollars from January to May ¶2009. Actual foreign investment flows during the first six months of 2009 are 90 percent below the first six months of 2008, according to MIER. GOM investment officials fear that once the recovery takes hold, foreign investors will bypass Malaysia in favor of lower cost options in China or Vietnam. They expressed hope the recent investment liberalization measures would bring new investment, but have not yet seen any significant new investments since the announcement.

KEITH